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News From the ICI Tax and Accounting Conference – IRS Releases Guidance on Commodity Subsidiary Distributions and Limitations on the Definition of a Security for RIC Qualification Purposes

Helen Hubbard with the IRS (Associate Chief Counsel, Financial Institutions and Products) spoke on a panel covering Current Tax Developments at the 2016 Investment Company Institute Tax and Accounting Conference on Monday, September 26, 2016, during which she discussed guidance that the IRS intends to release. Since the time of her announcement, the guidance (proposed regulations - REG-123600-16, available at <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-23408.pdf>) has been released by the IRS.

In summary, the guidance acknowledges that the SEC has exclusive jurisdiction to determine whether a particular investment made by a RIC is a security and requires a commodity subsidiary wholly-owned by a RIC to make an actual dividend distribution to the RIC in order for the income from the subsidiary to satisfy the RIC qualifying income test described below (some RICs have been treating deemed distributions of the commodity subsidiary's income as qualifying income).

In order to qualify for treatment as a regulated investment company (RIC), a fund must satisfy, among other things, the following requirements:

- **Income Test** – a Fund must derive at least 90% of its gross income from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock, securities or foreign currencies, or other income (including, but not limited to, gains from options, futures or forward contracts) derived from its business of investing in such stock, securities or currencies and net income derived from qualified publicly traded partnerships (QTPs).
- **Asset Diversification Test** – the Fund must satisfy the following asset diversification test at the close of each quarter of the Fund's tax year: (1) at least 50% of the value of the Fund's assets must consist of cash and cash items, U.S. government securities, securities of other regulated investment companies, and securities of other issuers (as to which the Fund has not invested more than 5% of the value of the Fund's total assets in securities of an issuer and as to which the Fund does not hold more than 10% of the outstanding voting securities of the issuer); and (2) no more than 25% of the value of the Fund's total assets may be invested in the securities of any one issuer (other than U.S. government securities or securities of other regulated investment companies) or of two or more issuers which the Fund controls and which are engaged in the same or similar trades or businesses, or, in the securities of one or more QTPs.

The proposed regulations relate to the income and the asset diversification requirements. The guidance covers the following:

- **Definition of "securities" for RIC qualification tests.** The income and the asset diversification tests both use the term "securities." Section 851(b)(2) states, in part, that "a corporation shall not be considered a RIC for any taxable year unless... at least 90 percent of its gross income is derived from— dividends, interest, payments with respect to

securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) [the (1940 Act)] or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies...” (Emphasis added.) (Section references are to the Internal Revenue Code of 1986, as amended.) Section 851(b)(3) contains the asset diversification test applicable to RICs wherein the definition of a security is relevant. Section 2(a)(36) of the 1940 Act currently defines a “security” as:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 851(c)(6) states that the terms used in Section 851(b)(3) have the same meaning as when used in the 1940 Act. An asset is therefore a security for purposes of the income and the asset diversification tests if it is a security under the 1940 Act.

The Treasury Department and the IRS have in the past addressed whether certain instruments or positions are securities for purposes of Section 851. For example, Revenue Ruling 2006-1 holds that a derivative contract with respect to a commodity index is not a security for purposes of Section 851(b)(2). The ruling also holds that income from such a contract is not qualifying other income for purposes of Section 851(b)(2) because that income is not derived with respect to the RIC’s business of investing in stocks, securities, or currencies. Revenue Ruling 2006-1 was modified and clarified by Revenue Ruling 2006-31, which states that Revenue Ruling 2006-1 was not intended to preclude a conclusion that income from certain instruments (such as certain structured notes) that create commodity exposure for the holder is qualifying income under Section 851(b)(2).



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In discussing Revenue Rulings 2006-1 and 2006-31, the preamble to the proposed regulations states, “After the issuance of Rev. Rul. 2006-31, the IRS received a number of private letter ruling requests concerning whether certain instruments that provide RICs with commodity exposure were securities for purposes of the income test and the asset diversification requirements. By 2010, the IRS was devoting substantial resources to these private letter ruling requests. Moreover, it is not clear whether Congress intended to allow RICs to invest in securities that provided commodity exposure. Consequently, in July 2011, the IRS notified taxpayers that the IRS would not issue further private letter rulings addressing specific proposed RIC commodity-related investments while the IRS reviewed the issues and considered guidance of broader applicability.”

Ms. Hubbard stated that the IRS would release guidance under which the IRS will no longer rule on whether a particular investment constitutes a security for purposes of Section 851. She stated that it is the IRS’s view that the SEC has exclusive rulemaking authority in this area. In this regard, the preamble to the proposed regulations state that, “...determining whether certain investments that provide RICs with commodity exposure are securities for purposes of the income test and the asset diversification requirements requires the IRS implicitly to determine what is a security within the meaning of section 2(a)(36) of the 1940 Act. Section 38 of the 1940 Act, however, grants exclusive rulemaking authority under the 1940 Act to the... SEC... Any future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is therefore within the jurisdiction of the SEC.”

As described in the proposed regulations, the IRS will no longer issue letter rulings on questions relating to the treatment of a corporation as a RIC that require a determination of whether a financial instrument or position is a security under the 1940 Act.

The guidance requests comments as to whether Revenue Rulings 2006-1 and 2006-31, and other previously issued guidance that involves determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn effective as of the date the proposed regulations are published as final regulations.

- **RIC and Commodity Exposure; Distributions from Commodity Subsidiaries.** Certain RICs establish a wholly owned subsidiary taxable as a “controlled foreign corporation” (CFC) under the Code, and the subsidiary invests in commodities or commodity-linked derivatives or other instruments that would generate non-qualifying income for the RIC if the RIC invested directly in those instruments. The CFCs also invest in fixed income and other securities to collateralize the subsidiary’s commodities derivatives positions. The CFC’s income and gains constitute “subpart F income” under Section 951(a)(1)(A) (i) that the RIC includes in its gross income, as ordinary income, in the taxable year of the RIC in which or with which the subsidiary’s tax year ends, regardless of whether the subsidiary actually distributes this income to the RIC. This subpart F income generally is not treated as a dividend for U.S. federal income tax purposes. The flush language in Section 851(b) provides, however, that the subpart F income of a CFC that a RIC is required to include in its gross income in a tax year under Section 951(a)(1)(A) (i) that is currently distributed to the RIC is treated as “dividends” for purpose of the RIC qualifying income test (therefore constituting qualifying income to the RIC). This left open the question of whether subpart F income that is not distributed by the CFC to the RIC and, therefore, not a “dividend” could be viewed as generating qualifying income to a RIC. The IRS issued numerous private letter rulings concluding that the undistributed subpart F income derived by a RIC from its CFC is income derived with respect to the RIC’s business of investing in the stock of the CFC and, therefore, constitute qualifying income pursuant to the other income clause of Section 851(b)(2).

Ms. Hubbard stated that the proposed regulations would modify the holding of the private letter rulings that undistributed subpart F income derived by a RIC from its CFC will be income derived with respect to the RIC’s business of investing in the stock of the CFC and, therefore, constitute qualifying income pursuant to the other income clause of Section 851(b)(2). In this regard, the preamble to the proposed regulations state:

Notwithstanding the distribution required by section 851(b), in certain circumstances the IRS has previously issued letter rulings under section 851(b)(2) that permit an inclusion under section 951(a)(1)(A)(i) or 1293(a) to qualify as “other income” derived with respect to a RIC’s business of

investing in currencies or 1940 Act stock or securities even in the absence of a distribution. Reading section 851(b)(2) in this manner ignores the requirement in section 851(b) that amounts be distributed in order to treat these inclusions as dividends. This distribution requirement is a more specific provision than the other income clause. In addition, it cannot be suggested that the distribution requirement was superseded by the other income clause because the other income clause and the distribution requirement for inclusions under section 1293(a) were both added by the 1986 Act. Therefore, these proposed regulations specify that an inclusion under section 951(a)(1)(A)(i) or 1293(a) is treated as a dividend for purposes of section 851(b)(2) only to the extent that the distribution requirement in section 851(b) is met. These proposed regulations further provide that, for purposes of section 851(b)(2), an inclusion under section 951(a)(1) or 1293(a) does not qualify as other income derived with respect to a RIC’s business of investing in stock, securities, or currencies.

Therefore, according to the proposed regulations, only subpart F income that is currently distributed by the CFC to the RIC will satisfy the income test applicable to RICs.

As described by Ms. Hubbard the proposed regulations will become effective for taxable years of the RIC beginning at least 90 days after the proposed regulations are published as final regulations. The private letter rulings issued to date will remain in effect for now. Once final regulations are issued the private letter rulings will no longer be effective, at least with respect to the proposition that undistributed subpart F income derived by a RIC from its CFC will be income derived with respect to the RIC’s business of investing in the stock of the CFC and, therefore, constitute qualifying income to the RIC.

The proposed regulations also clarify that the distribution requirement extends to passive foreign investment company (PFIC) securities held by a RIC. A RIC that invests in a PFIC normally cannot cause the PFIC to make an actual distribution to the RIC. Most RICs, however, market their PFIC investments to market (as opposed to making a qualified electing fund election) thereby making it certain that a RIC’s income from a PFIC investment satisfies the income test.

IRS Disregards Transaction Steps in Proposed Reorganization

In Private Letter Ruling 201638004 (<https://www.irs.gov/pub/irs-wd/201638004.pdf>), in a proposed reorganization of an S corporation, the IRS ruled that: (a) it will disregard several transaction steps for purposes of determining whether the taxpayer who engaged in the transaction will realize gain or loss under Section 1001 or be treated as having engaged in a Section 368(a)(1)(F) reorganization (section references are to the Internal

Revenue Code of 1986, as amended); (b) the disregarded steps will be treated as direct transfers of the business; and (c) the entity's S corporation election will not terminate.

Draft of 2016 Form 1120, U.S. Corporation Income Tax Return and Instructions Released

The IRS released a draft of Form 1120 (https://www.irs.gov/pub/irs-dft/f1120--dft.pdf?_ga=1.118253258.236391105.1446132583) along with its instructions (https://www.irs.gov/pub/irs-dft/i1120--dft.pdf?_ga=1.172191456.236391105.1446132583). The instructions note the change of due date, i.e., the 15th day of the fourth month after the end of the corporation's tax year. A new question was added to the form for corporations making payments that require a corporation to file Forms 1042 and 1042-S.

IRS Corrects Final Net Asset Value Method Regulations

As published, the final regulations (TD 9774 at <https://www.gpo.gov/fdsys/pkg/FR-2016-09-23/pdf/2016-22945.pdf>) (see prior coverage at <http://www.stradley.com/insights/publications/2016/tax-insights-2016/tax-insights-july-13-2016>) contained an error that Treasury noted may prove to be misleading and, therefore, was in need of clarification. Specifically, on page 44512, in the preamble, the first column, under the heading "7. Accounting Method Changes," the ninth line of the second full paragraph, the language "Proc. 2016-39 (2016-30 IRB), which" was corrected to read "Proc. 2016-39 (2016-30 IRB 164), which."

CRS Analyzes Corporate Tax Integration Issues

In a Sept. 20 report (<http://www.stradley.com/~media/Files/Publications/2016/congressional-research-service-2016-19011-1.pdf>), the Congressional Research Service examined corporate tax integration and reform options. The report first examines the four traditional efficiency issues by comparing effective tax

rates, and then outlines several proposals to integration. Finally, the report compares the proposals with respect to impact on revenue, administrative feasibility, and effects on both traditional and international tax choices.

Dominican Republic-U.S. FATCA Agreement Available

The text is available of the agreement (<https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-DominicanRepublic-9-15-2016.pdf>) signed by the Dominican Republic and the United States to improve international tax compliance and implement the information reporting and withholding tax provisions of FATCA.

California Approves Federal Conformity Bill for Business Filing Dates

California Gov. Jerry Brown signed a bill (AB 1775 available at http://www.leginfo.ca.gov/pub/15-16/bill/asm/ab_1751-1800/ab_1775_bill_20160914_chaptered.pdf) that requires, for taxable years beginning on or after Jan. 1, 2016, a partnership and a limited liability company classified as a partnership to file a return on the 15th day of the third month, and a taxpayer subject to the Corporation Tax Law, but not an "S corporation," to file a return on the 15th day of the fourth month, following the close of its taxable year. These tax return due dates conform to federal income tax return due dates for taxable years beginning on and after Jan. 1, 2016.

California FTB Adopts Market-Based Sourcing Rules for Intangible Property

The California Franchise Tax Board adopted amendments (https://www.ftb.ca.gov/law/regs/25136-2/Final_Text.pdf) to market-based sourcing rules that clarify the sourcing rules for sales of marketable securities and interest gross receipts from intangible property.

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